Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

Author:	AR&T Committee	Analyst:	John Pavalasky	Bill Number:	AB 1740
Related Bills:	See Legislative History	Telephone:	845-4335	Introduced Date:	March 11, 2003
		Attorney:	Patrick Kusiak	Sponsor:	Franchise Tax Board

SUBJECT: Child and Dependent Care Credit (California CDC) For Nonresidents and Part-Year Residents/AB 1115 Clean-Up/Resolves a Constitutional Issue Regarding The Alimony Deduction

SUMMARY

This bill contains three Franchise Tax Board sponsored changes, as follows.

- **AB 1115 Clean-up** - Clarifies the method of calculating the taxable income of nonresidents and part-year residents to eliminate concerns that were identified during the implementation of AB 1115 (Stats. 2001, Ch. 920).

- **California CDC** - Corrects a drafting error made when the California child and dependent care ("CDC") credit was enacted in 2000, as well as a cross-reference error created from a law change made in 2002. These corrections specify the definition of adjusted gross income (AGI) that would be used when calculating the amount of the credit for all residents, nonresidents, and part-year residents.

- **Resolve a potential federal constitutional issue** - Allows a nonresident taxpayer a prorated alimony deduction.

PURPOSE OF THE BILL

This bill would ease the administration of California's laws and potentially improve compliance by nonresident taxpayers.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would be effective immediately and operative for taxable years beginning on or after January 1, 2003.

POSITION

Support.

On November 26, 2002, the Franchise Tax Board voted 2-0 to sponsor the language discussed in Items 1 and 2 of this bill. At its December 18, 2000, meeting, the Franchise Tax Board voted 2-0 to sponsor language substantially similar to the language discussed in Item 3.

Board Position:			Department Director	Date
______ S	______ NA	______ NP	Gerald H. Goldberg	04/04/03
______ SA	______ O	______ NAR		
______ N	______ OUA	__X__ PENDING		

ECONOMIC IMPACT

The net revenue impact of this bill would be a negligible revenue gain of less than $250,000 annually.

Estimated Revenue Impact Effective January 1, 2003 [$ In Millions]			
	2003-04	2004-05	2005-06
1. AB 1115 Clean-Up	No Impact	No Impact	No Impact
2. California CDC	Minor* Gain	Minor* Gain	Minor* Gain
3. Nonresident Alimony Deduction	Negligible** Loss	Negligible** Loss	Negligible** Loss
Net Impact of Bill	**Negligible** Gain**	**Negligible** Gain**	**Negligible** Gain**

*Minor less than $500,000
**Negligible less than $250,000

Each of these three changes will be discussed separately.

1. AB 1115 (Stats. 2001, Ch. 920) Clean-up

ANALYSIS

FEDERAL/STATE LAW

For taxable years beginning on or after January 1, 2002, a nonresident first determines the “average tax rate” that would apply to a resident having the same amount of total taxable income (TI) for the year. The second step is to then multiply that person’s California source TI by the “average tax rate” determined in step one. The mathematical formula is:

$$\frac{\text{Tax on Total TI}}{\text{Total TI}} \times \text{California Source TI} = \text{Tax}$$

This formula clearly provides that the “average tax rate” is applied only to TI having a California source and is, therefore, consistent with the federal constitutional principle that California lacks jurisdiction to tax nonresidents on income from sources outside this state.

In order to determine the “average tax rate” that would apply to a resident having the same amount of total TI for the year, current law provides that “taxable income of a nonresident or part-year resident” is to be determined on the entire TI of the nonresident or part-year resident as if the nonresident or part-year resident were a resident of this state for the taxable year, and as if the nonresident or part-year resident were a resident of this state for all prior taxable years for any carryover items, deferred income, suspended losses, or suspended deductions.

Current law also provides that when calculating the "taxable income of a nonresident or part-year resident," the amount of carryover items, deferred income, suspended losses, or suspended deductions shall only be includible or allowable to the extent that these items were derived from sources within this state. Thus, in order to determine the amount of California source TI that will be taxed at the "average tax rate," the amount of income and deductions must be recalculated on a source basis.

During the implementation of AB 1115 (Stats. 2001, Ch. 920), certain issues were identified that may be subject to more than one interpretation and, thus, need to be clarified.

1. AB 1115 added a definition of "California adjusted gross income" in Revenue and Taxation Code (R&TC) Section 17301.3 to reflect the definition of that term that was contained in R&TC Section 17041, prior to its amendment by AB 1115. However, the new definition explicitly provides how a California nonresident is to determine their income from sources within this state but does not explicitly reflect the repeal of former R&TC Section 17303 that provided a rule for the sourcing of income of part-year residents during the period of residency.

2. R&TC Sections 17041(d)(2) and 17041(i)(1)(B) each contain an incorrect cross-reference.

3. Concerns have been raised regarding the sufficiency of the language contained in R&TC Section 17041(i)(3) with respect to the calculation of the amount (on a source basis) to be included in the "taxable income of a nonresident or part-year resident" of carryover items, deferred income, suspended losses, and suspended deductions by a nonresident or part-year resident (for the period of nonresidency).

   A. An analysis of R&TC Sections 17041(c)(2) and 17041(d)(2) shows that when a nonresident or part-year resident calculates his or her "average tax rate," they do so in the same manner as a California resident, that is, as if the nonresident or part-year resident were a resident of this state for the taxable year and as if the nonresident or part-year resident were a resident of this state for all prior taxable years for any carryover items, deferred income, suspended losses, or suspended deductions.

   B. R&TC Section 17041(i)(3) provides that when calculating the "taxable income of a nonresident or part-year resident," the amount of carryover items, deferred income, suspended losses, or suspended deductions shall only be includible or allowable to the extent that these items were derived from sources within this state. In other words, this paragraph, by implication, provides that the amount is to be calculated on a source basis for the current year and all prior years. However, this paragraph does not explicitly state the calculation is to be made as if the nonresident or part-year resident (for the period of nonresidency) was a nonresident for all prior years.

4. AB 1115 did not contain relief from estimated tax penalties for taxpayers being required to report more income under AB 1115 than under prior law.

THIS BILL

This bill would:

1. Amend R&TC Section 17301.3 to explicitly reflect the repeal of former R&TC Section 17303 and the change made to R&TC Section 17041 with respect to part-year residents.

2. Amend R&TC Section 17041(d)(2) to change the reference from subdivision "(a)" to "(c)" to correct the cross-reference to the head of household tax rates and R&TC Section 17041(i)(1)(B) to change the reference from "Section 17031" to "Section 17301" to correct the cross-reference to the beginning section of Article 9 of Chapter 3.

3. Amend R&TC Section 17041(i)(3) to explicitly provide that in calculating the "taxable income of a nonresident or part-year resident," the calculation of prior year items is to be made as if the nonresident or part-year resident (for the period of nonresidency) was a nonresident for all prior years.

4. Add R&TC Section 19136.11 to waive estimated tax penalties for the 2002 taxable year.

IMPLEMENTATION CONSIDERATIONS

This bill would improve the department's administration of state tax law by eliminating an area of ambiguity. Some tax forms and instructions would require change, but this could be accomplished during the normal annual update of forms and procedures.

LEGISLATIVE HISTORY

AB 1115 (Stats. 2001, Ch. 920) made major changes to the manner that nonresidents and part-year residents compute their tax for taxable years beginning on or after January 1, 2002, to ensure that California does not tax nonresidents and part-year residents (for the period of nonresidency) on income from sources outside this state.

OTHER STATES' INFORMATION

The states surveyed include *Florida, Illinois, Massachusetts, Michigan, Minnesota, and New York.* These states were selected due to their similarities to California's economy, business entity types, and tax laws.

Florida has no comparable method of taxation of nonresidents of that state since it has no personal income tax.

Illinois allocates and apportions the income of nonresident individuals to determine the amount of income that is sourced to and, thus, is taxable by that state. Income of a part-year resident is sourced to Illinois for the part of the year that the individual was a resident, and apportioned inside and outside of the state for the part of the year the individual was a nonresident.

Under *Massachusetts* law, a nonresident is taxed only on income from sources within that state. Nonresidents are entitled to deductions only to the extent they relate to or are allowable against the income subject to tax in Massachusetts. The corporate rules for apportionment of income are used to determine the amount sourced and, thus, taxable where the nonresident has income from sources both inside and outside of the state. If the individual changes from resident to nonresident, or vice versa, during the year, the taxpayer is required to file two returns (i.e. a resident return for the portion of the year during which the taxpayer was a resident and a nonresident return for the other portion of the year).

Michigan provides that the TI of a nonresident is allocated to the state to the extent it is attributable to personal services rendered in Michigan or that is derived from business activities carried on in the state. Allocation and apportionment rules are provided for items such as business income, rents and royalties, gains and losses, interest and dividends, and income from patents and copyrights.
New York taxes nonresidents and part-year residents on TI derived from sources within the state. The New York source income of a nonresident is the amount of federal AGI derived from or connected with New York sources, including allowing a nonresident a deduction for alimony paid using the same ratio that their business income is apportioned to New York. The source income of a part-year resident is the sum of the federal AGI for the period of residence plus the New York source income for the period of nonresidence and certain special accruals.

FISCAL IMPACT

This bill may result in minor but indeterminable departmental savings.

ECONOMIC IMPACT

Revenue Estimate

This change would not impact the State's revenue.

Revenue Discussion

This change is clean-up to AB 1115, providing clarification on the calculation of prior year items of a nonresident (carryover items, deferred income, etc.) to prevent future controversies.

ARGUMENTS/POLICY CONCERNS

California law should contain clear guidelines with respect to the tax treatment of the income and deductions of nonresidents and part-year residents. This bill would establish explicit rules that would be applied consistently to all taxpayers. It would ease the administration of California's laws and improve compliance by California taxpayers.

Some taxpayers and their representatives will support these changes since they eliminate ambiguity in the law and will reduce the number of audits, protests, and appeals.

Also, this bill is consistent with the fundamental federal constitutional principle that nonresidents of a state are subject to tax by that state only upon their income from sources within that state.

2. California CDC

ANALYSIS

FEDERAL/STATE LAW

Current Federal Law

Existing federal law allows a non-refundable tax credit known as the federal Child and Dependent Care Credit (federal CDC). In order to take this credit, a taxpayer must have employment-related child and dependent care expenses for the care of a qualifying individual.

A qualifying individual for purposes of this credit is any dependent of the taxpayer who is under the age of 13 or a taxpayer's dependent or spouse who is physically or mentally unable to care for him or herself. Employment-related child and dependent care expenses are generally defined as those expenses incurred to enable gainful employment, e.g., housekeeping, babysitting, and other household services.

Taxpayers must pay over half the cost of keeping up their primary home for the qualifying individuals. Costs include rent, mortgage interest, real estate taxes, utilities, home repairs, and food eaten at home.

Beginning in 2003, the maximum amount of eligible employment-related expenses will be $3,000 for one qualifying individual and $6,000 for two or more qualifying individuals. The maximum credit amount will be 35%. Thus, the maximum credit is $1,050 if there is one qualifying individual and $2,100 if there are two or more qualifying individuals.

Current State Law

Existing state law allows a credit similar to the federal CDC. California tax law conforms to federal tax law regarding the amount and types of expenses and qualifying individuals for purposes of claiming the California CDC. The amount of the California CDC is simply based on a percentage of the taxpayer's federal CDC. However, California AGI is used to determine the applicable percentage of federal CDC that may be claimed for the California CDC. This allows a nonresident and part-year resident with a low California AGI and a high federal AGI to claim the CDC where a resident with the same total income or federal AGI will not be able to claim the CDC.

Unlike the federal CDC, the California CDC is refundable.

The credit is limited to those taxpayers who maintain a household within the state. However, the law does not specify that the care for the qualifying individual must be within the state. Consequently, claimants are able to include expenses incurred in other states in the calculation of their California CDC.

Generally, credits allowed to nonresident and part-year resident taxpayers are prorated using the ratio of AGI from sources within California over AGI from all sources. A credit is allowed in its entirety if the credit is conditioned upon a transaction wholly occurring in this state.

THIS BILL

This bill would make the following changes in R&TC Section 17052.6:

- Refer to the appropriate AGI definition when determining the percentage,
- Delete the requirement for the taxpayer to maintain a home in California, and
- Clarify that employment-related child and dependent care expenses are required to have occurred within the state for purposes of the California CDC.

IMPLEMENTATION CONSIDERATIONS

Implementing this bill would require some changes to tax forms and instructions but this could be accomplished during the normal annual update of forms and procedures.

OTHER STATES' INFORMATION

The states surveyed include *Florida, Illinois, Massachusetts, Michigan, Minnesota, and New York.* These states were selected due to their similarities to California's economy, business entity types, and tax laws.

Florida only has a corporation income tax therefore the CDC is not applicable.

Illinois and *Michigan* do not offer a credit or a deduction to taxpayers for child and dependent care expenses.

Massachusetts does not allow a credit but allows taxpayers a deduction that exceeds the federal limit on employment related expenses for dependent care services. Nonresidents and part-year residents must prorate this deduction based upon the amount of their Massachusetts-sourced income to total income.

Minnesota allows taxpayers a refundable credit similar to California's CDC. However, it is not a percentage of the federal CDC but instead is based on household income level. Nonresidents, part-year residents, and Native Americans must prorate the credit based on the amount of earned income taxable to Minnesota.

New York also allows taxpayers a refundable credit similar to California's CDC. It is based on a percentage of the federal CDC depending on the amount of the taxpayer's New York AGI. For nonresidents, the amount to be refunded is based on the New York income adjustments made to the federal AGI. For part-year residents, the amount to be refunded is based on the ratio of resident period income to the combined income from both the resident and nonresident periods.

FISCAL IMPACT

No departmental costs are associated with this change.

ECONOMIC IMPACT

Revenue Estimate

This FTB sponsored change would result in a projected minor revenue gain in the $300,00 to $450,000 range annually beginning in fiscal year 2003-4. The following is a breakdown of this range:

It is projected that using federal AGI instead of California AGI would result in a revenue gain on the order of $300,000. To determine the revenue gain, the total number of nonresident taxpayers claiming the California CDC based on California AGI was compared to the number of nonresident taxpayers who would claim the CDC based on their federal AGI. Of those two groups, only the taxpayers whose allowable credit percentage would change were counted for this estimate. For instance, those taxpayers who were claiming a 63% credit under California AGI when required to use the federal AGI would now claim the 53%, 42%, or zero credit. A ratio was calculated between the difference of California AGI and federal AGI percentages. This ratio was multiplied by the total number of nonresident CDC returns that was then multiplied by the average amount of credit claimed per nonresident CDC return. This results in a minor gain to state tax revenues because there would be fewer nonresident taxpayers who could claim the CDC.

It is projected that requiring employment-related child and dependent care expenses to be incurred within the state would result in an insignificant gain of less than $150,000 to California state tax revenues because only a small group of nonresident taxpayers would be affected by this change.

ARGUMENTS/POLICY CONCERNS

This bill would correct a drafting error made when the California CDC was enacted in 2000 and correct a cross reference error created from a law change in 2002. Specifically, it would provide the appropriate definition for AGI and would ensure the proper amount of credit for all residents, nonresidents, and part-year residents.

This bill would also reduce the number of nonresident taxpayers who claim the credit because they maintain a vacation home in California or are in California for a transitory period of time but incur employment-related child and dependent care expenses for the qualifying individual outside of California.

3. Resolve a potential federal constitutional issue

ANALYSIS

FEDERAL/STATE LAW

Current Federal Law

Payments of alimony or separate maintenance made under a divorce or separation instrument are deductible by the payor's spouse under Internal Revenue Code (IRC) Section 215 and taxable to the payee spouse under IRC Section 71.

Current State Law

California law is substantially the same as the New York law that was held to be unconstitutional by the United States Supreme Court in *Lunding Et Ux.* v. *New York Appeals Tribunal et al.* (1998) 118 S.Ct. 766. In determining California-source income, current law does not allow a deduction for alimony payments made by either a nonresident or a part-year resident during the time they are a nonresident, even if paid to a California resident. This provision denying a deduction was first introduced in 1957.

The justification for this rule appears to have been that because California does not tax nonresident taxpayers on alimony income, nonresidents should not be allowed an alimony deduction. However, because alimony cannot be deducted while a nonresident, it would appear that this constitutes, under *Lunding,* an impermissible categorical denial of deductions to nonresident taxpayers.

The California Constitution, however, prohibits an administrative agency from refusing to enforce a California statute on the grounds that it is unconstitutional, unless an appellate court has determined that such statute is unconstitutional. Unless the statute is amended, the department will be required to continue to enforce it unless an appellate court rules otherwise.

THIS BILL

This bill would allow the alimony deduction to California nonresidents consistent with the *Lunding* decision to resolve a Federal Constitutional issue. This would be accomplished by amending R&TC Section 17302. The amendment would provide that the deduction for alimony payments is **allowed** to a nonresident or part-year resident in the same ratio (not to exceed 1.00) that "California AGI" for the entire year, computed without regard to the alimony deduction, bears to "total AGI" for the entire year, computed without regard to the alimony deduction. This ratio is consistent with the treatment of adjustments to income for nonresidents under current law as amended by AB 1115 (Stats. 2001, Ch. 920).

IMPLEMENTATION CONSIDERATIONS

This bill would improve the department's administration of state tax law by eliminating a federal constitutional issue.

LEGISLATIVE HISTORY

This bill has been the subject of prior legislation, but was never enacted. It was included in legislation (AB 1115) in 2001, but was removed from that bill during Senate Appropriation Committee hearings based on the bill's estimated $5 million revenue loss. In 2002, the revenue impact was reexamined and was revised to reflect an insignificant revenue loss by examining actual tax returns claiming this deduction.

PROGRAM BACKGROUND

The United States Constitution, under what is known as the Privileges and Immunities Clause, provides that the citizens of each state are entitled to all the privileges and immunities of the citizens of all the states.

In 1998 the United States Supreme Court considered the application of this clause to a New York statute denying nonresidents an alimony deduction in computing New York adjusted gross income.

In *Lunding Et Ux.* v. *New York Appeals Tribunal et al.* (1998) 118 S.Ct. 766, the Court struck down the New York statute holding that New York's categorical denial of the deduction to nonresidents violated the Privilege and Immunities Clause of the Federal Constitution, stating that New York had not substantially justified its discriminatory treatment of nonresidents. Although New York's nonresident alimony statute, New York Tax Law Section 631(b)(6), is worded differently than California's R&TC Section 17302, the effect is identical.

OTHER STATES' INFORMATION

The states surveyed include *Florida, Illinois, Massachusetts, Michigan, Minnesota,* and *New York.* These states were selected due to their similarities to California's economy, business entity types, and tax laws.

Florida has no comparable method of taxation of nonresidents of that state since it has no personal income tax.

Illinois and *Michigan* allow the alimony paid by a nonresident to be deducted in arriving at adjusted gross income.

Under *Massachusetts* law, if a nonresident pays alimony to a Massachusetts resident, the nonresident may deduct the alimony paid.

New York allows a nonresident a deduction for alimony paid using the same ratio that their business income is apportioned to New York.

FISCAL IMPACT

This change may result in minor but indeterminable departmental savings.

ECONOMIC IMPACT

<u>Revenue Estimate</u>

This FTB sponsored change allows a nonresident taxpayer a prorated alimony deduction and is estimated to be a negligible loss to PIT revenue, less than $250,000 annually. These estimates reflect various factors including the amount of alimony paid by and average apportionment factor of California nonresidents and part-year residents based on the department's PIT samples.

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

ARGUMENTS/POLICY CONCERNS

This bill would ease the administration of California's laws and potentially improve compliance by nonresident taxpayers.

Some taxpayers and their representatives will support this bill because it would resolve a federal constitutional issue. Also, it would reflect a fair tax policy by providing the same tax benefit to both residents and nonresidents of California.

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